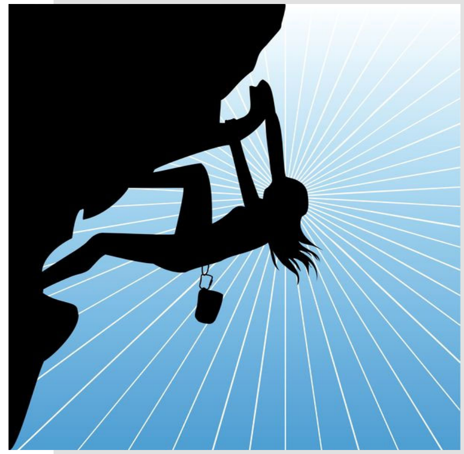
DECEMBER 2019

Climbing The Wall of Worry

By United Capital Seattle



Source: 123rf.com

While the media-at-large has recently been focused on the risk of recession, trade and worsening economic reports abroad, U.S. equity markets are meanwhile hitting new highs, forcing many investors to ask themselves if they're being overly cautious. Last year's violent fourth quarter sell-off was predicated by an escalating of the U.S. - China trade dispute and a Federal Reserve which was still raising interest rates. This year, it's the opposite on both counts. Following the third rate cut of the year, Fed Chair Powell said on October 30th that the Federal Open Market Committee (FOMC) "would need to see a really significant move up in inflation that's persistent before we even consider raising rates to address inflation concerns."[1] Given those factors along with an increasing likelihood of a Brexit deal and strong employment picture, it's not surprising that the market seems to be taking a "glass half-full" view on a number of issues. This month we're changing things up, leaving the market's biggest worries behind and reviewing some of the key debates dominating the financial news.

Earnings

Expectations heading into the third quarter of 2019 earnings reporting season were feared to be weak, with profits expected to decline from the third quarter of 2018. While headline earnings growth was down -2.4% from the third quarter of 2018, those fears did not fully materialize as consensus expectations were about four percentage points worse.[2] Excluding the energy sector, S&P 500 earnings growth would have been flat in the third quarter, similar to the second quarter's performance. This is important as we think about the fourth quarter and 2020 earnings, as the drag from energy-specific earnings should be smaller in the fourth quarter and provides a lower base from which to grow overall 2020 earnings.[3] Additionally, tighter financial conditions in 2018 were a headwind to 2019 earnings growth, but the easier year-to-date financial conditions should be supportive of earnings growth going forward. Thus, we believe a lower hurdle for a positive earnings surprise in the fourth quarter and 2020 as well exists.

Revenues are also beating low expectations, the absolute level is only anticipated to be up 3.1% in the quarter.[4] That would be the lowest quarterly growth rate for the index since the third quarter of 2016. International sales are a key factor behind that slower growth. According to Factset, companies in the S&P 500 that generate more than 50% of sales outside of the U.S. are projected to actually see revenues decline by 2.2% and earnings decline by 7.4%. Those S&P 500 constituents getting greater than 50% of revenues from the U.S. should see a 4.9% increase in revenue and flat earnings growth.[5] A strong U.S. dollar, slowing global growth and the continued Sino-American trade dispute are, in our view, likely having an impact on the resilience of firms generating the majority of their business in the U.S versus the rest of the world.

As we look ahead into 2020, our colleagues at Goldman Sachs Portfolio Strategy Research have a baseline forecast of S&P 500 earnings per share growing 6% to $174, over 2019's estimate of $165.[6] While Goldman Sachs Portfolio Strategy Research feels that political and policy uncertainty will keep the S&P 500 range-bound next year, it nevertheless suggests a continuation of the current profit cycle and an 11th year of the bull market in US equities. Our office would agree that overall conditions still appear supportive of modest earnings growth, especially if US economic growth can meet or exceed expectations. US economic growth is the most important driver of S&P 500 EPS, explaining more than half of the variation in annual S&P 500 EPS growth since 1990.[7]

Interest Rates - Yield Curve Is No Longer Inverted

Over the summer and into early fall, the yield curve inverted, sending longer-term yields, namely the 10-year yield, below those of short-term yields, namely the 3-month yield and for a brief period the 2-year yield. While there are several dynamics that impact interest rates, in this instance we believe that muted levels of inflation and slowing economic growth were two primary factors leading to the fall in yields. Additionally, interest rates around much of the rest of the world were falling and many developed market interest rates went further into negative territory. This further pushed down US. interest rates as demand for positive yield from overseas made U.S. Treasuries relatively more attractive to negative yielding debt.[8] Beyond the stimulative monetary policies of the world's developed economies, Evercore International Strategy & Investment (ISI) points out that there have been 59 emerging market central banking easing actions over the past 4 months.[9]

In response to the weakening economic data, in July 2019 the FOMC cut its benchmark interest rate by 0.25% for the first time in 11 years, in what it dubbed a "mid-cycle adjustment."[10] This was followed by a second 0.25% rate cut at the FOMC's September meeting, and a third 0.25% rate cut at the October meeting. In the most recent 0.25% rate cut, the tone from the FOMC minutes and subsequent press conference by Chairman Powell indicated that the new Fed Funds rate is "appropriate" unless any new information forces them to "materially reassess" their position.[11]

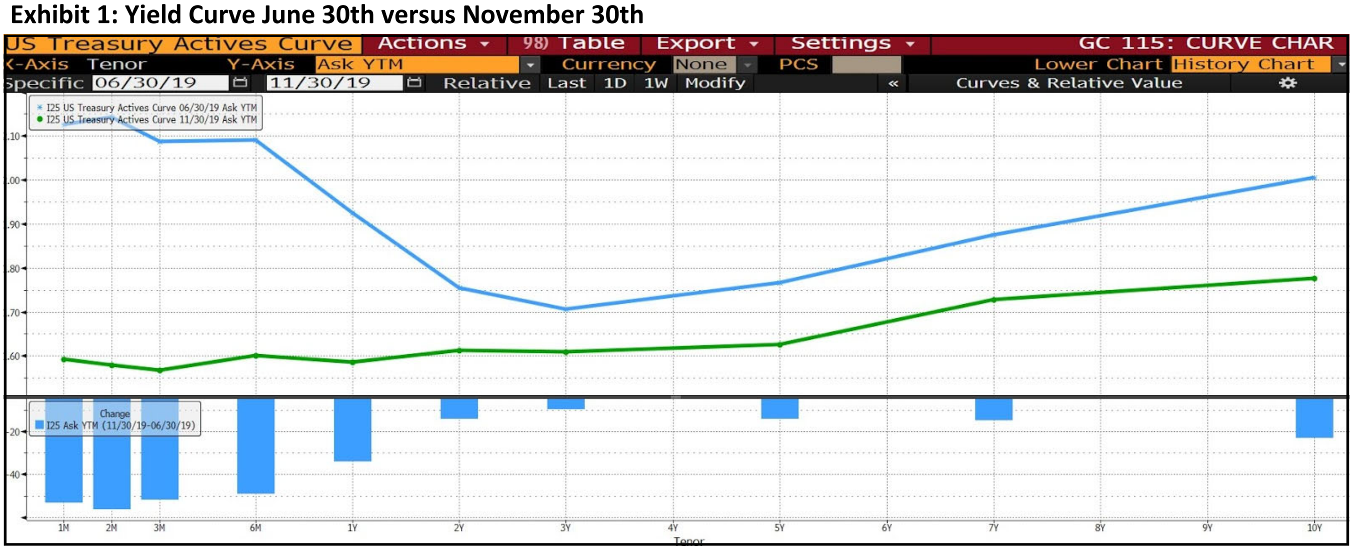
As we pen this letter, the current Fed Funds rate sits at 1.5%-1.75% (the green line in Exhibit #1 below) and the yield curve, which had been inverted as of June, looks normal in that longer-term investments now require an additional risk premium.[12] That said, the notion of the Fed remaining on hold is predicated on an outlook where growth remains at trend, the consumer and labor market remain strong and inflation begins to move back towards 2%.[13] It is our belief that the easing by the Fed and other central banks around the world is likely to be at least somewhat stimulative for future economic growth in the coming quarters.

According to Evercore ISI, one variable which results from monetary stimulus and drives growth in their real GDP model is consumer net worth. In the fourth quarter, consumer net worth is up almost 10% year over year due to the rise in stock prices and home prices.[14] This isn't a new idea. Ben Bernanke wrote in a 2010 editorial defending quantitative easing that "lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Fed Easing - Don't Call It A Comeback, It's Been Here For Years

On October 11th the Fed announced it would begin to buy short-dated Treasury bills at the pace of around $60B per month, with the purchases continuing until at least the second quarter of 2020. The subsequent timing and amount of monthly purchases will vary, "as necessary to maintain an ample supply of reserve balances over time."[15] This announcement came after some unusual activity in repurchase agreements caused interest rates to jump in September. While this will increase the supply of bank reserves in the financial system in an attempt to prevent a repeat of such unusual activity, it looks and feels much like the quantitative easing programs on which the Fed embarked in previous years. Chairman Powell has been vocal that this current balance sheet expansion is not quantitative easing and it is distinct from previous asset buying programs that focused on longer-dated treasuries and mortgages.[16]

Exhibit 1: Yield Curve June 30th versus November 30th



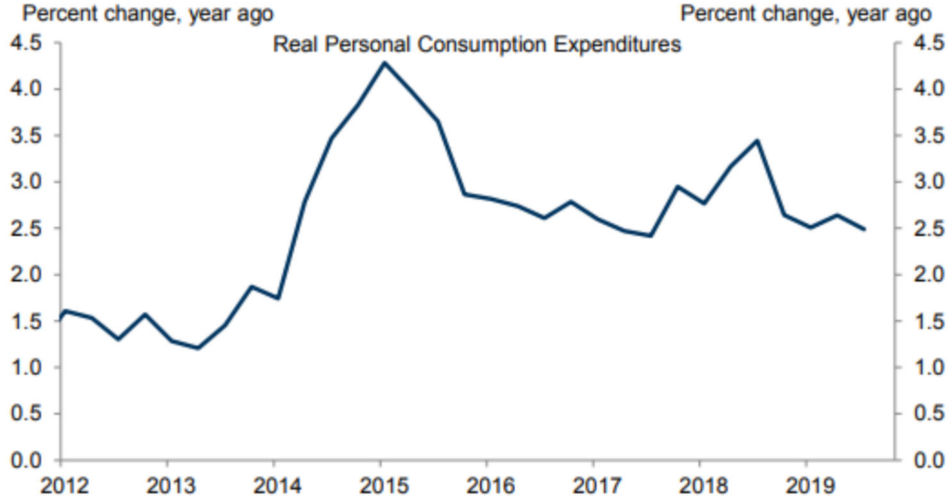
Source: Bloomberg

However, in our office's view, if it looks like a duck, swims like a duck and quacks like a duck, then is it really not a duck? We will continue to watch the timing and amounts of these purchases.

US Manufacturing Slowdown Spillover Risks

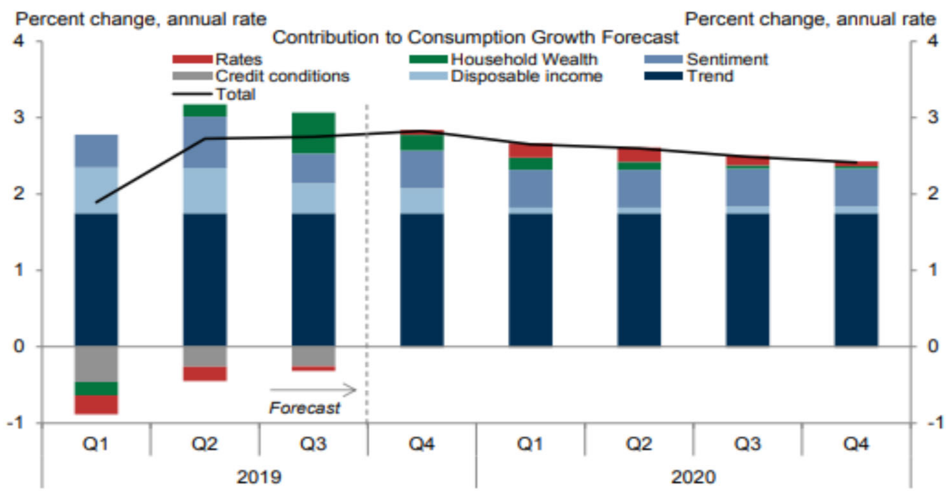
In November, U.S. manufacturing activity contracted for the fourth straight month and missed market expectations, noting global trade "remains the most significant cross-industry issue."[17] This has, in our opinion, raised concerns that a manufacturing slowdown may spread to the labor market and/or consumer spending. It is worth noting that manufacturing made up only 11% of U.S. gross domestic product (GDP) in the second quarter of 2019, its smallest share of GDP since 1947. Further, factory jobs as a share of total payrolls are near the smallest share on record.[18] It seems to us that the Trump administration's campaign agenda to bring manufacturing jobs back home has been offset by the ongoing trade war and weakening manufacturing around the rest of the world.

Exhibit 2: The Consumer Has Remained Resilient



Source: "Consumption Leads the Way," US Economics Analyst, Goldman Sachs Economic Research, 11.02.19

Exhibit 3: The Consumer Should Remain Strong Into 2020



Source: "Consumption Leads the Way," US Economics Analyst, Goldman Sachs Economic Research, 11.02.19

We are of the mind that the smaller share of manufacturing constituting GDP and payrolls makes it unlikely that a manufacturing slowdown will quickly spread to the much larger consumer portion of the U.S. economy. This can be seen from the initial third quarter GDP growth estimate of 1.9%, which was above consensus expectations of 1.6% as consumer spending continued to grow at a strong pace.[19] According to Michael Darda, Chief Economist and Market Strategist at MKM Partners, "what we have here is a strong consumer so far offsetting a business investment recession and an incipient downturn in the profit cycle."[20]

Our colleagues at Goldman Sachs Economics Research note (in Exhibit #2) that real personal consumption has remained strong at 2.5% growth over the last year. In the 3rd quarter it did decelerate from the second quarter of 2019, to a rate of 2.9% from 4.6%, but overall, the consumer, which represents over two-thirds of the U.S. economy, remains the key growth driver.[21]

Business fixed investment was down -3%, declining for a second consecutive quarter and further illustrating the current manufacturing slowdown.[22] Outside of personal consumption, one particularly strong area in this most recent GDP report was residential investment. It grew at 5.1%, rising for the first time in 7 quarters, as lower interest rates had a positive impact on home construction and sales.[23] Overall the report indicates that growth has slowed, as was expected, but the consumer continues to be a major growth driver, reaffirming our team's belief that the recession in business fixed investment may not significantly spill over to the consumer at this time. Goldman Sachs Economic Research would tend to agree that consumption should remain strong into 2020, based on their consumption model, saying in a November 2nd U.S. Economics note, "we find no evidence that weak capex is associated with subsequent weakness in consumption."[24] (See Exhibit #3)

MARKET STATS

S&P 500	3141
DOW JONES	28051
10 YR T-BOND	1.78%

As of 11/30/2019
Source: Bloomberg

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Conclusion

While some of these topics have the potential to move the needle on the economy, it's more likely that neither the most pessimistic, nor the most optimistic views will again prove correct. Of course, when good news dominates the headlines, markets are trending higher, and we're entering the months of the year which are typically strong, it's normal to see "FOMO" (fear of missing out) overcome market participants as well. If only it were that easy. Closer analysis suggests that the economic environment is mixed, and importantly, businesses globally remain cautious, in our view. The Federal Reserve's support of risk assets is an obvious positive, but monetary policy isn't a cure-all for the economy and capital markets.

Our team in Seattle believes that we are not in the early stages of this economic cycle, and it is our opinion that a balanced approach to risk continues to be appropriate. Given paltry yields in bond markets, equity markets continue to look modestly attractive when considering downside risks. Bonds markets are an important indicator, in our view. A move in yields either higher (potentially indicating inflation) or lower (potentially indicating recession) might be an indicator that a change in strategy may be necessary. As we near the end of the year we believe quality companies, with business models able to compound earnings year after year, continue to be prudent investment options. At the same time, we continue to monitor the economic backdrop with vigilance as this economic expansion (now the longest on record in the US) will eventually come to an end.

Footnotes:

1 "OCT FOMC Commentary – Not Planning On Going Lower, But Low For Longer For Inflation Favors Risk," Evercore ISI Global Policy & Central Banking Strategy Macro Note, 10.30.19
2 Monthly Market Monitor, Investment Strategy Group, Goldman Sachs, November 2019
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4 https://insight.factset.com/sp-500-earnings-season-update-november-15-2019
5 "Resilient Corporate Profits Soothe Fears of a Slowdown" Wall Street Journal, Banerji, Gunjan, 11.01.19
6 2020 US Equity Outlook: United we fall, divided we rise, Goldman Sachs Portfolio Strategy, 11.25.19
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9 Morning Economic Report, Evercore ISI, Hyman, Ed, 12.03.19
10 https://www.cnbc.com/2019/08/21/federal-reserve-releases-minutes-from-july-meeting.html
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13 "Oct FOMC Commentary - Not Planning On Going Lower, But Low For Longer For Inflation Favors Risk," Evercore ISI Global Policy & Central Banking Strategy, 10.30.19
14 Evercore ISI, Morning Economic Note, October 29, 2019
15 "Fed Unveils Plan to Expand Balance Sheet but Insists It's Not Q.E.," nytimes.com, Smialek, Jeanna, 10.11.19
16 "Fed Unveils Plan to Expand Balance Sheet but Insists It's Not Q.E.," nytimes.com, Smialek, Jeanna, 10.11.19
17 Institute for Supply Management, ISM Report on Business - Manufacturing, November 2019 report
18 "Manufacturing Is Now Smallest Share of U.S. Economy in 72 Years," Bloomberg News, 10.29.19
19 "USA: Q3 GDP Above Expectations on Consumer Strength and Inventory Resilience," Goldman Sachs Economic Research, Hill, Spencer, 10.30.19
20 "MacroStrategy, Q3 GDP & Other Observations," Michael Darda, MKM Partners, 10.30.19
21 "Consumption Leads the Way," US Economics Analyst, Goldman Sachs Economic Research, 11.02.19
22 "USA: Q3 GDP Above Expectations on Consumer Strength and Inventory Resilience," Goldman Sachs Economic Research, Hill, Spencer, 10.30.19
23 "USA: Q3 GDP Above Expectations on Consumer Strength and Inventory Resilience," Goldman Sachs Economic Research, Hill, Spencer, 10.30.19
24 "Consumption Leads the Way," US Economics Analyst, Goldman Sachs Economic Research, 11.02.19